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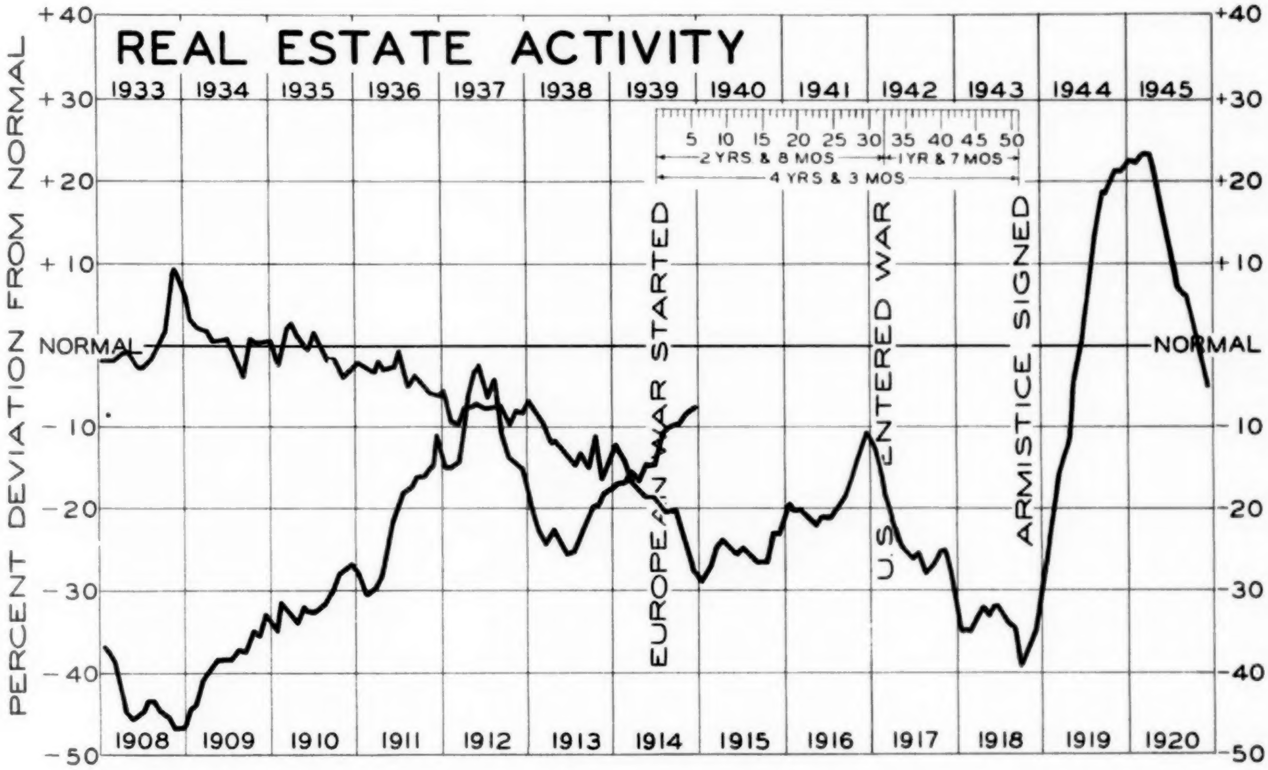
Editor

A concise easily digested periodic analysis based upon scientific research in real estate fundamentals and trends... Constantly measuring and reporting the basic economic factors responsible for changes in trends and values.....Current Studies.... Surveys....Forecasts

VOLUME IX

REAL ESTATE ECONOMISTS, APPRAISERS AND COUNSELORS

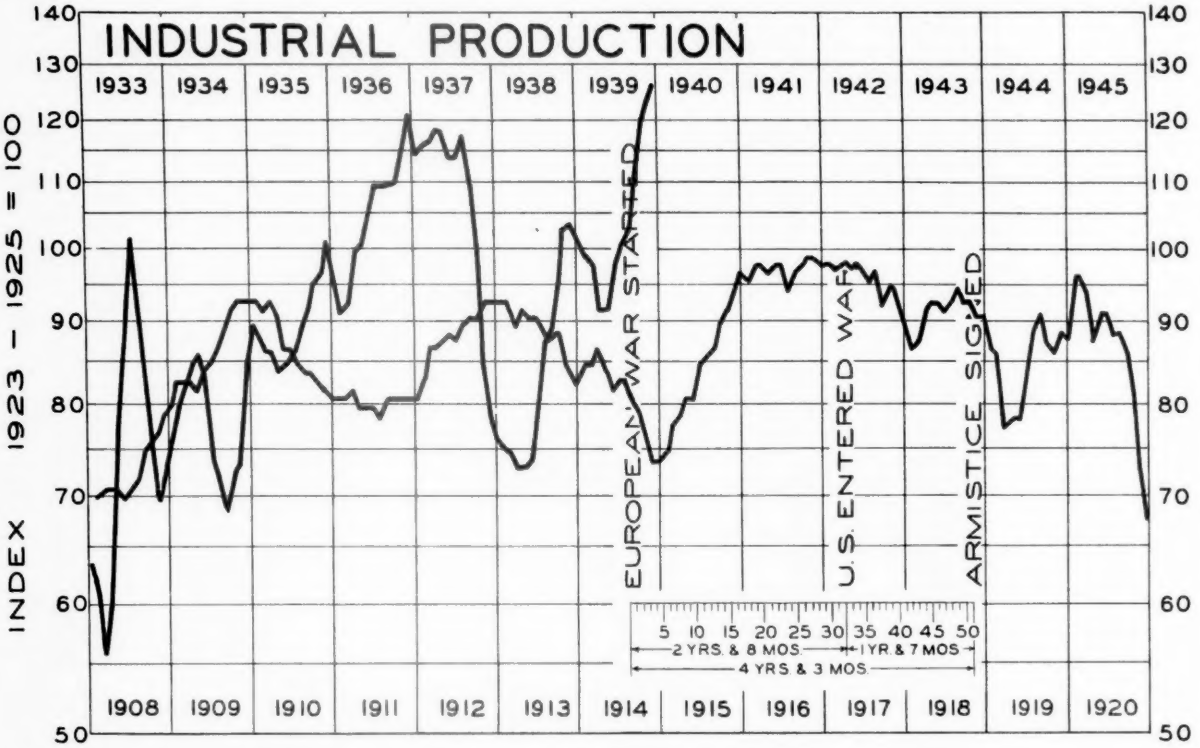


WAR AND THE REAL ESTATE FACTORS

IN this report we are bringing up to date the charts which we published in September at the beginning of the present war. We have now had four months of war and have some basis of comparison with the World War in 1914.

The chart above shows a comparison of real estate activity in the pre-World War period, during the war and the period immediately after, with real estate activity from 1933 to the present. The World War curve is drawn in red, the recent past in black. The two lines are so drawn that the beginnings of the World War in 1914 and the present war are superimposed.

This chart especially, is one in which no similarity can be found between the reactions in the two wars. In each case real estate activity followed the trend which had started long before the beginning of the war. Had there been no World War in 1914, real estate activity would in all probability have still drifted down much as it did, due primarily



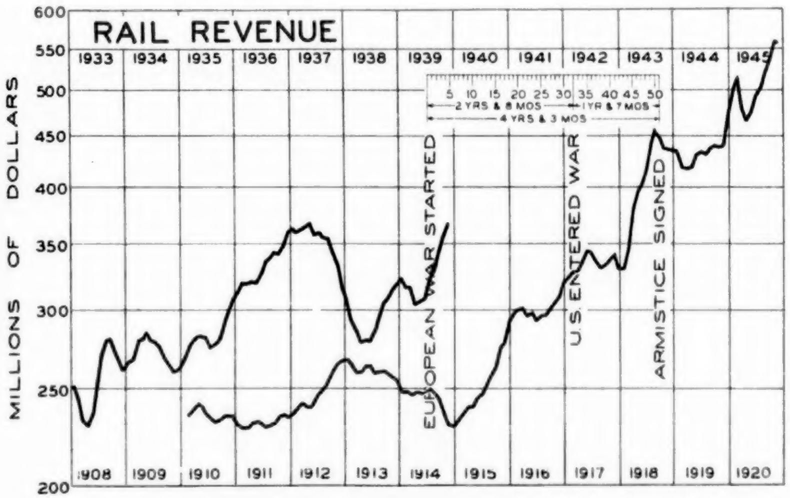
to the fact that the boom of the early nineteen hundreds had oversupplied the market. War or no war, we expect real estate activity to increase now as a natural reaction from the lows of the nineteen thirties. We think that in 1940 it will cross the normal line.

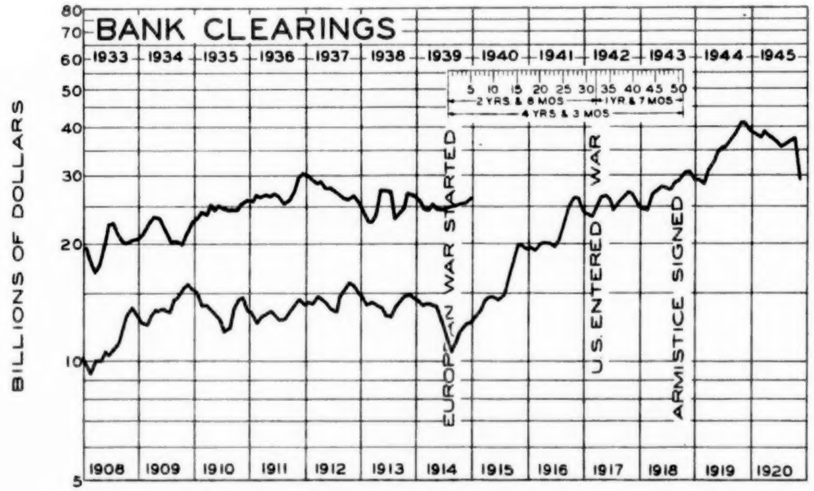
The chart above on industrial production is based on the figures compiled by the Federal Reserve. It is not adjusted for population growth which accounts for the relatively high levels of the last few years in relation to the pre-World War rates.

The recovery in industrial production since the summer of 1938 has been truly remarkable and only the later part of this rise can be attributed to the war.

Clearly, the December, 1939, level cannot be maintained for long without interruption. We believe that currently the rate of production is above the rate of new orders and that after a period of catching up, inventories will start to accumulate. Business executives are quite cautious, however, and will endeavor to keep the machine in balance. In our opinion, January will do well to approach 120, with February around 115, and March still lower. While these levels are considerably below the December figure, they are far above the 1939 figures for the same months-- January 101, February 99, and March 98.

Should the European war this spring leave the "sit-down strike" stage and become a really destructive war, industrial production would advance faster than otherwise. We think this is entirely possible, but regardless of European developments, we think 1940 as a whole will exceed 1939.





In our opinion rail revenue is a good indicator of the business situation, being affected considerably by the heavy industries. The figures on rail revenues are available from 1910 to date. It will be noticed on the chart that after the outbreak of the World War rail revenues dropped considerably for a few months' time before they started their rapid rise.

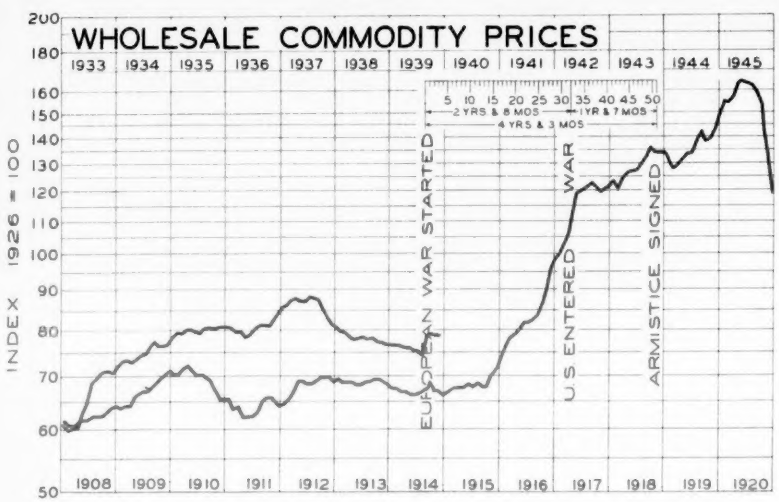
At the beginning of this war rail revenues turned up quite sharply, and the advances have been quite satisfactory thus far. The revival of the capital goods industries now taking place should result in a continuation of the upturn.

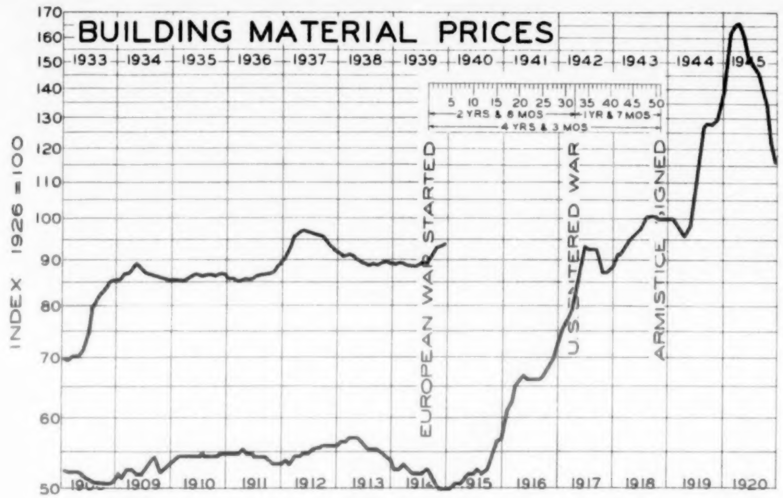
We expect that the next few years will be far better years for the railroads than the last six. Truck competition has not been as serious a deterrent to their recovery as has been the lack of shipments in the heavy goods fields.

The chart above shows a comparison of bank clearings in the period from 1908 to 1914 with the comparable period from 1933 to 1940. It also shows the period from 1914 to 1920 with the result of the World War on general business.

It will be noticed that, immediately prior to the beginning of the World War, bank clearings dropped materially, but that very shortly after the beginning of the war they started rising at a rapid rate. At the end of the first year they had advanced almost 60%; at the end of five years they were approximately three and one-half times greater than at the outbreak of the war.

The chief difference in the curve showing the recent past is the absence of the drop preceding and at the time of the beginning of war. We think 1940 will show sizable increases as the year progresses.





FROM the chart above it can be seen that the present war has caused a more rapid price reaction than was caused in 1914. In 1914, prices dropped after the war started and it was a full year before the rapid rise started.

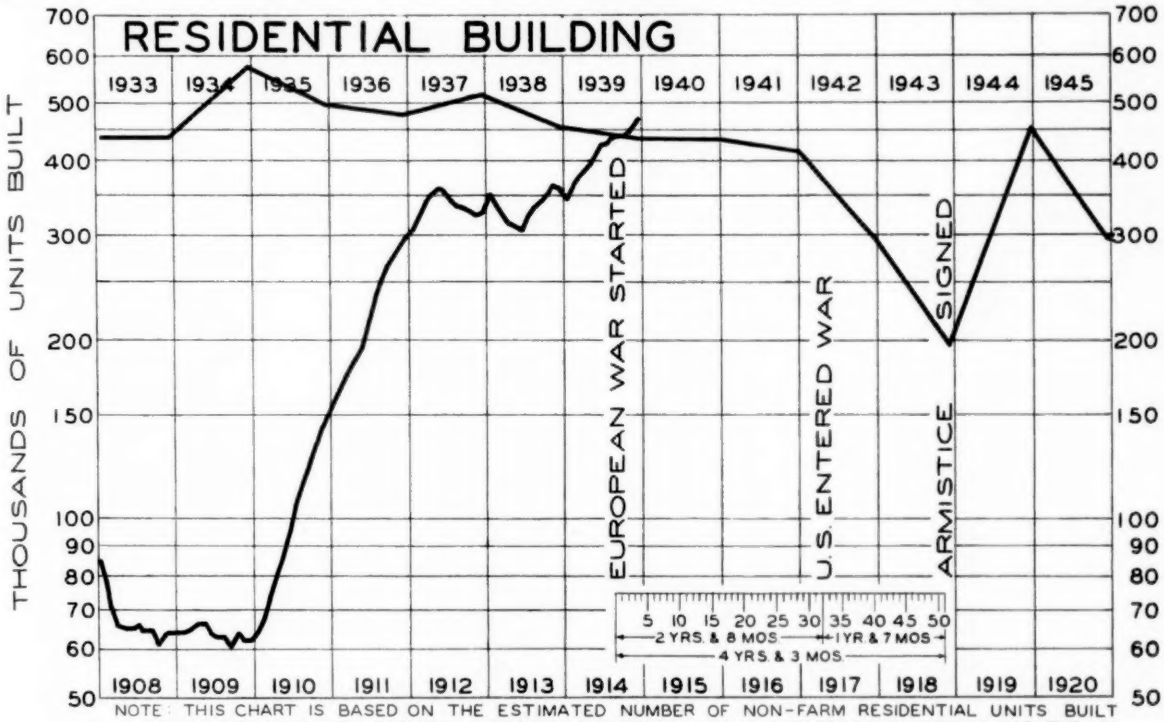
We think the rise already experienced is all that is justified by present demand and supply relationships, and we rather look for a period of little change during the next few months followed by further rises later in the year.

A fast and furious war this spring would probably cause prices to rise faster. During the last war, commodities advanced in price by 142%. If the war continues, we think a comparable rise is entirely probable during the next few years.

The charts above are based on the index figures compiled by the Bureau of Labor Statistics.

BUILDING material prices are charted above in a fashion similar to general commodities. It will be noticed that during the last war building materials increased in price along with the increases in general commodities. The percentage of increase from 1914 to 1920, however, was far greater for building materials, a 218% rise against 142% for general commodities.

The war reaction in 1914 and in 1939 was totally different. In 1914, prices dropped sharply when the war started; in 1939, they rose sharply, even in the face of government investigations and prosecutions. We think it entirely probably that the rise will flatten out for the next few months before it starts upward again. It seems to us that there are many reasons why we can expect building costs to rise during the next few years, and that the probability is for a rise of considerable size.



NOTE: THIS CHART IS BASED ON THE ESTIMATED NUMBER OF NON-FARM RESIDENTIAL UNITS BUILT IN THE U.S. BY 12 MONTH PERIODS. MONTHLY FIGURES AS PLOTTED REPRESENTS TOTALS FOR THE 12 MONTHS PRECEDING.

In our forecast for new building in 1939 we said that "it seems to us as if residential building might increase by from 40 to 60% in comparison with 1938." According to the F. W. Dodge figures for contracts awarded in the 37 eastern states, residential building in 1939 exceeded 1938 on a dollar basis by 35.5%, and, on the basis of new dwelling units by 55.0%. Our forecast was higher than that of any other group.

We forecast an increase in commercial building of from 10% to 30%. According to the Dodge figures, the increase on a dollar basis was 14.5%, and on the basis of floor area, 16.8%.

Our forecast for factory buildings was an increase of from 25% to 45% above 1938. According to Dodge, the increase, on a dollar basis, was 44.5%, and on the basis of floor area, 76.0%. We missed on "Other Construction" which includes a great deal of government financed work. Our forecast was an increase of from 10% to 25% over 1938; the actual was 4.2% below 1938. This over estimating of government construction caused us also to over estimate total construction. We estimated 25% to 50% increase over 1938; the actual was 11.0% in dollars or 19.6% in floor area.

Our estimates for 1940 are as follows:- RESIDENTIAL building, an increase of from 5% to 15% above the 1939 total; COMMERCIAL, an increase of from 10% to 20% above the 1939 figures; INDUSTRIAL, an increase of from 25% to 60% above 1939. Other construction will, we believe, show a loss sufficient to reduce the 1940 total construction figure from a minimum of the same level to a maximum of 10% above 1939. If the U.S. should become involved in the European War, or if war should terminate suddenly, these figures would need immediate revision. We think that neither is a probability for 1940.

Our reasoning in brief behind these forecasts is as follows:

RESIDENTIAL BUILDING:- Under private initiative, residential building takes place for only two reasons, the first being that buildings can be built at the current construction cost level to sell or rent in competition with buildings already standing, and the second being that financing is so easy that the profit which the builder makes will equal or exceed the assumed equity in the property.

Our forecasts a year ago were made under basic conditions far different from those prevailing today. At that time rents had been advancing gradually for a number of years, vacancy had been dropping, and construction costs had been fairly constant. In the face of these facts we felt warranted in forecasting a 40% to 60% increase in residential building. In looking at the same factors today, however, we find that during the past year, rents have shown practically no change in most cities, and have dropped slightly in others. Vacancy has not been reduced, but is slightly higher today in some communities than it was a year ago. Building costs have advanced by about 4%, with the probability of additional advances during 1940. The figures of the Federal Housing Administration would seem to add further confirmation of this change in basic conditions. A year ago as we went to press with our forecast issue mortgages selected for appraisal by the F H A were exceeding the corresponding month of the preceding year by anywhere from 115% to 160%, and mortgages accepted for insurance were exceeding the preceding year each month by 85% to 118%. Now the reverse is true. Both mortgages selected for appraisal and mortgages accepted for insurance have, as a rule during the past few months, been slightly below the corresponding months of the year ago.

On the other hand, it seems likely that residential building under the direct supervision of the government will run higher in 1940 than it did in 1939. This will offset to some extent the unfavorable factors listed above.

Another factor which should carry some increase in 1940 in residential construction is the new provision for insuring loans on $2500.00 houses with only a 5% down payment. We think that this will open a market which has previously been untapped. However, we are inclined to believe that this building will not catch hold immediately, and that more can be expected in the latter part of the year than in the first part of the year.

Attempting to balance the favorable and unfavorable factors has led us to the opinion that residential building in 1940 may range between 5% above the 1939 figures to 15% above.

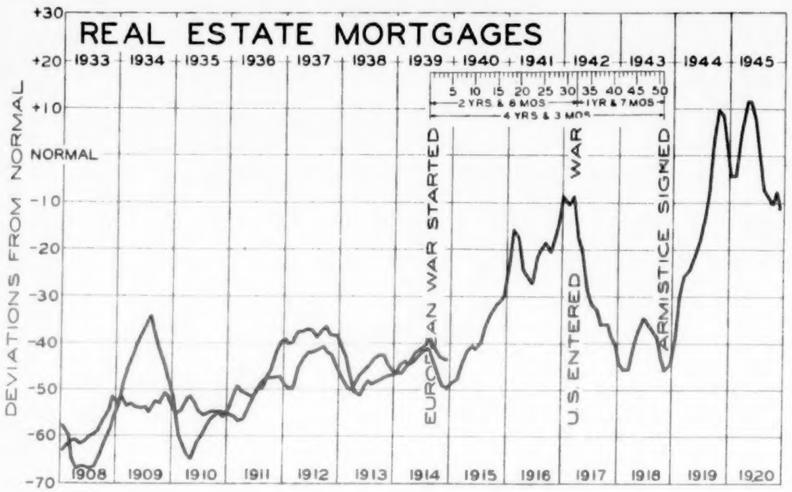
COMMERCIAL BUILDING:- Our forecast for commercial building is based on the following factors: During 1938 and 1939 office building vacancy showed a very slight absorption in the average city. At the present time it runs 17.7%, a figure too high to justify any great volume of building. There are a few cities, however, where office building vacancy

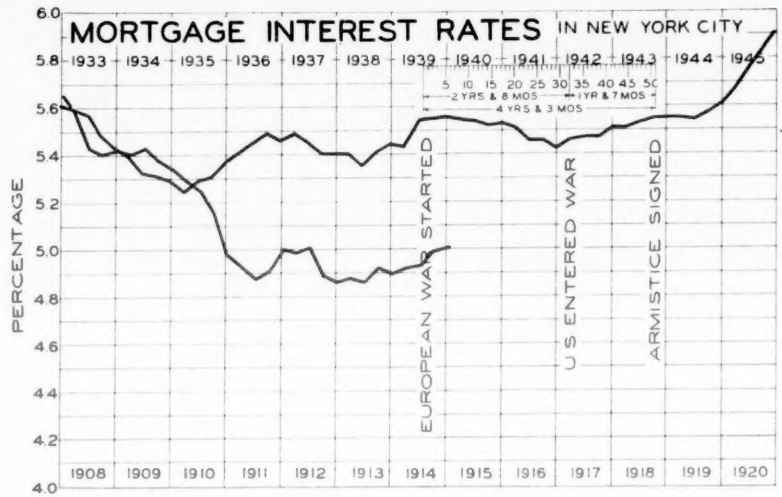
at the present time is quite low. Of the 56 cities shown on the office building vacancy chart in our November 24th report, 14 had a percentage of vacancy of 10% or less. In some of these cities there will be opportunity to build additional space, but in our opinion there will not be much commercial building of the larger type for the next two or three years at least, since this type of building always follows rather than precedes a real estate boom. There is opportunity in most cities to build shopping space, since a great deal of the present shopping space is neither well located nor designed. It is largely because of this building of stores and shopping space that we think commercial building will exceed a year ago by from 10% to 20%.

INDUSTRIAL BUILDING:- Industrial building fluctuates with industrial earnings almost entirely. We are assuming that 1940 is going to be a better year for industry than 1939 with some plant expansions. The forecast of a percentage increase of from 25% to 60% above 1939 may seem large, but it must be remembered that there has been relatively little industrial building during the depression, and that even a small volume in 1940 will constitute a large percentage increase.

IT is superfluous to state that it is unusually difficult to forecast this year. The wiser course would, undoubtedly, be to refuse. However, a man faced with concrete decisions to make on real estate cannot refuse to make them merely because clouds obscure a clear view of the future. A lease must or must not be renewed before a certain date; an offer must be accepted or rejected; a property must be held or let go under foreclosure. These decisions cannot wait until clouds lift or the light gets brighter.

Realizing this practical problem, we have done our best to interpret the forces which can be measured. We are not making these forecasts, however, as final pronouncements for 1940, but rather as the best opinion we can give in January, to be revised from time to time as the year progresses.





Mortgage volume depends on two things, the financing of new building and the refinancing of properties already built.

In the chart above, the line showing mortgage volume during the past six years more nearly parallels the pre- World War period than do any of the other lines we have charted in this Bulletin.

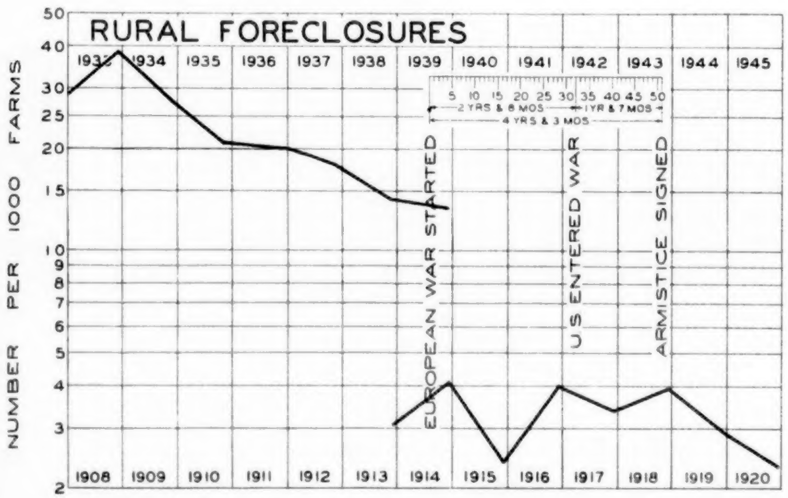
We are inclined to believe, however, that this parallelism will not continue during the next few years. We do not anticipate as rapid a rise in mortgage volume as occurred in 1915 and 1916, although we think it entirely possible that 1940 and 1941 will show an upward trend.

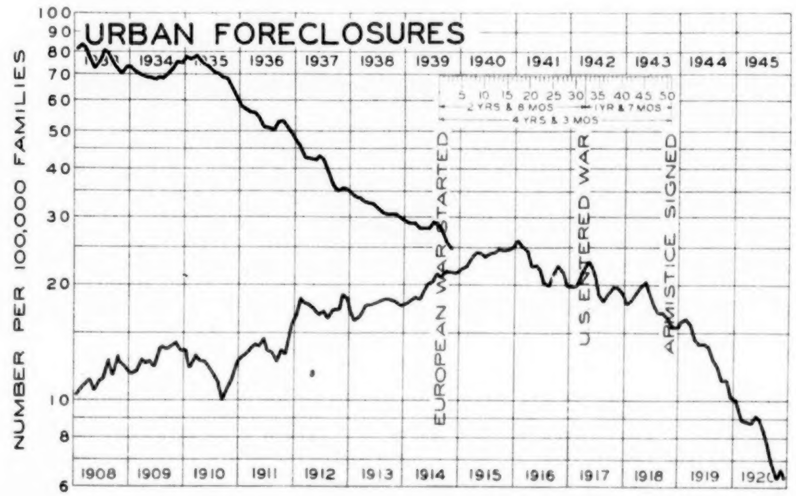
If the insuring of $2500.00 houses becomes common, it may increase the mortgage debt tremendously, particularly in some southern states. We think this will not occur in large volume in 1940.

The chart above shows the mortgage interest rate in New York City from 1908 to 1920, and from 1933 to the present. It is computed by averaging the rates charged on all new mortgages, but it excludes purchase money mortgages, extensions, inter-family transactions, agreements, etc.

It will be noticed that mortgage interest rates dropped quite rapidly from 1933 through 1936. Since the middle of 1938 there has been a slow but steady upward drift in the line.

Interest rates advanced only slightly at the beginning of the World War. This was possibly due to the fact that interest rates at that time for real estate were already quite high. A distress rate, on the other hand, like the rate we have had during the past few years is far more susceptible to a bettering of conditions than a higher rate.



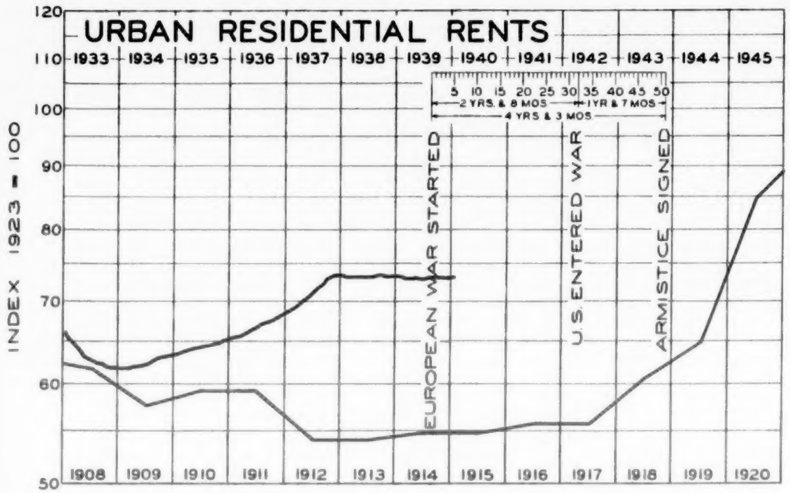


It will be noticed from the chart above showing foreclosures of farm properties, that during the World War period, foreclosures were practically negligible. The very high foreclosures of the period from 1933 to the present are, of course, an aftermath of the overexpansion of farmers during the period culminating in the twenties. In place of paying off mortgages on their farms during the period of high farm prices, a large number of farmers bought additional acreage with part purchase money mortgages at high rates of interest. With the collapse of high farm prices in 1920 and 1921 many of these loans ran into difficulties, but a large number were able to struggle along during the twenties until the collapse of prosperity in the cities ushered in the real depression.

Farm foreclosures should continue to drop and, if the war continues for a rather long period, should again reach a very low level.

Urban foreclosures have been following a trend during the past six years totally different from the trend which preceded the beginning of the World War. As a result of the real estate boom in the early 1900's, with its over-building, and over-financing of properties, foreclosures were rising steadily during the period from 1908 to 1915. Had there been no World War in 1914, the peaks of 1915 and 1916 would, in all probability, still have occurred.

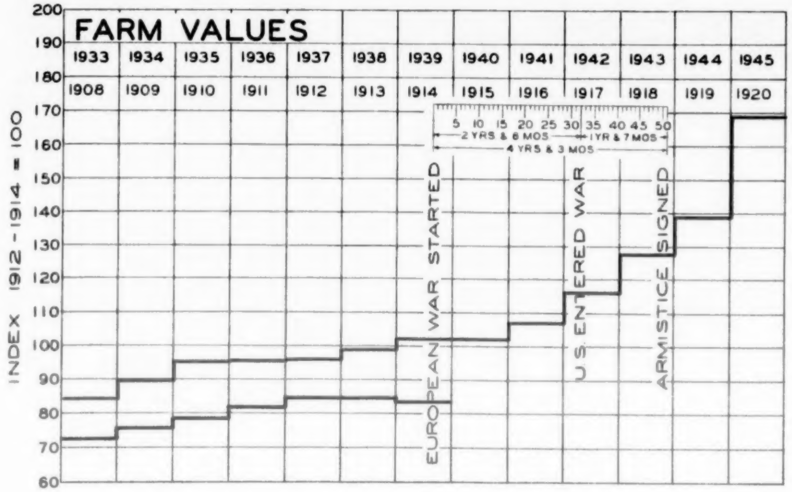
Since the beginning of 1935 the drop in the foreclosure rate has been quite satisfactory, and we believe the drop will continue at approximately the same rate during the next few years. We believe that by 1942 foreclosures should be at a level not higher than half of their 1939 average. New mortgages, providing for amortization and made on a fairly conservative basis, are far safer at the present than they were at any time in the twenties.



The chart above shows the progress of urban rents in principal cities. It will be noticed that the trend was down in the six years preceding the beginning of the World War in 1914, but after the war started the trend was slightly upward until 1917. Then the real rise started,accelerating after the Armistice, and reaching the maximum level in the early 20's.

The trend during the past few years has been different than it was in the pre-1914 period. Until two years ago the trend was upward. Because of the depression of 1937 and 1938 it leveled out, and has been moving sideways.

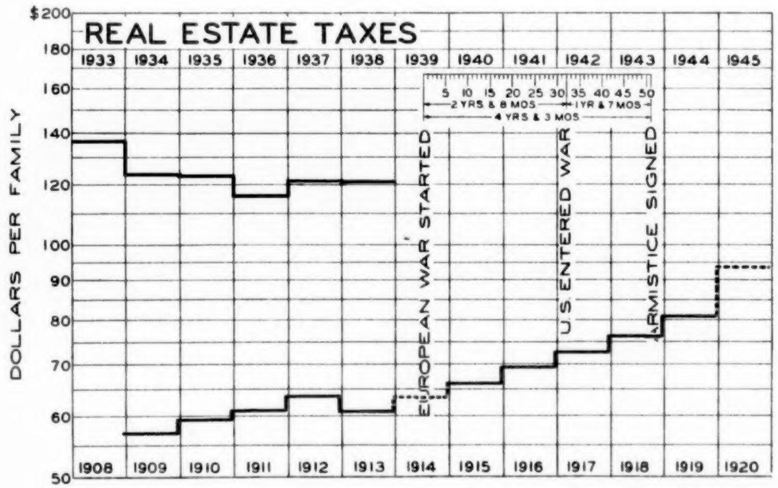
We think this sideways movement will continue during the first part of 1940, but, if general business starts ahead at an accelerated rate in the latter part of the year, we think it entirely possible that rents will again start upward.



The chart above shows the value of farms per acre before and after the last World War, in comparison with the period starting in 1933.

It will be noticed that each year from 1908 to 1920 showed an increase in farm values per acre. This was merely a continuation of a trend which in a rough fashion went back to 1850, with a sideways movement from 1870 to 1900. From 1920 to 1933 the trend was strongly downward, and only a slight degree of recovery has taken place during the past six years. Farm values in 1939 were actually lower than they were in 1938.

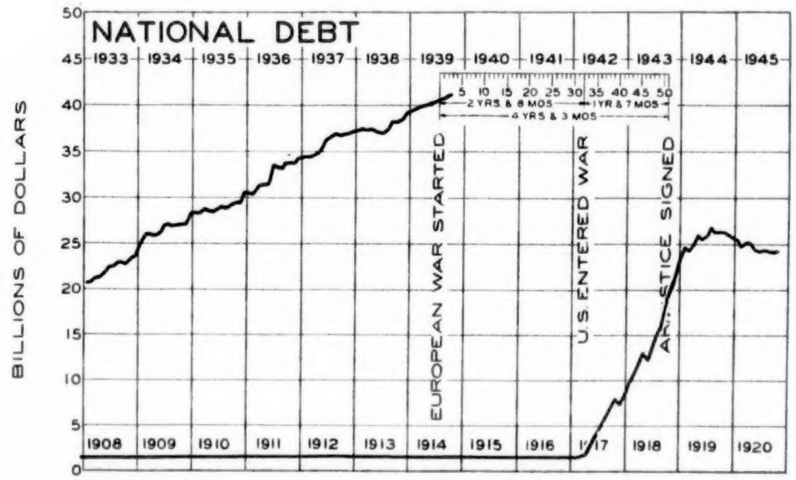
We are under the impression that in 1940 farm values will show a slight rise, and if the war continues, the values in the spring of 1941 should be higher still. Unless the U. S. enters the war we will not see the high farm values of the last war repeated.



The chart above shows the average real estate tax load per family in the U.S. It is based on all of the cities in the U.S. which have more than 100,000 population.

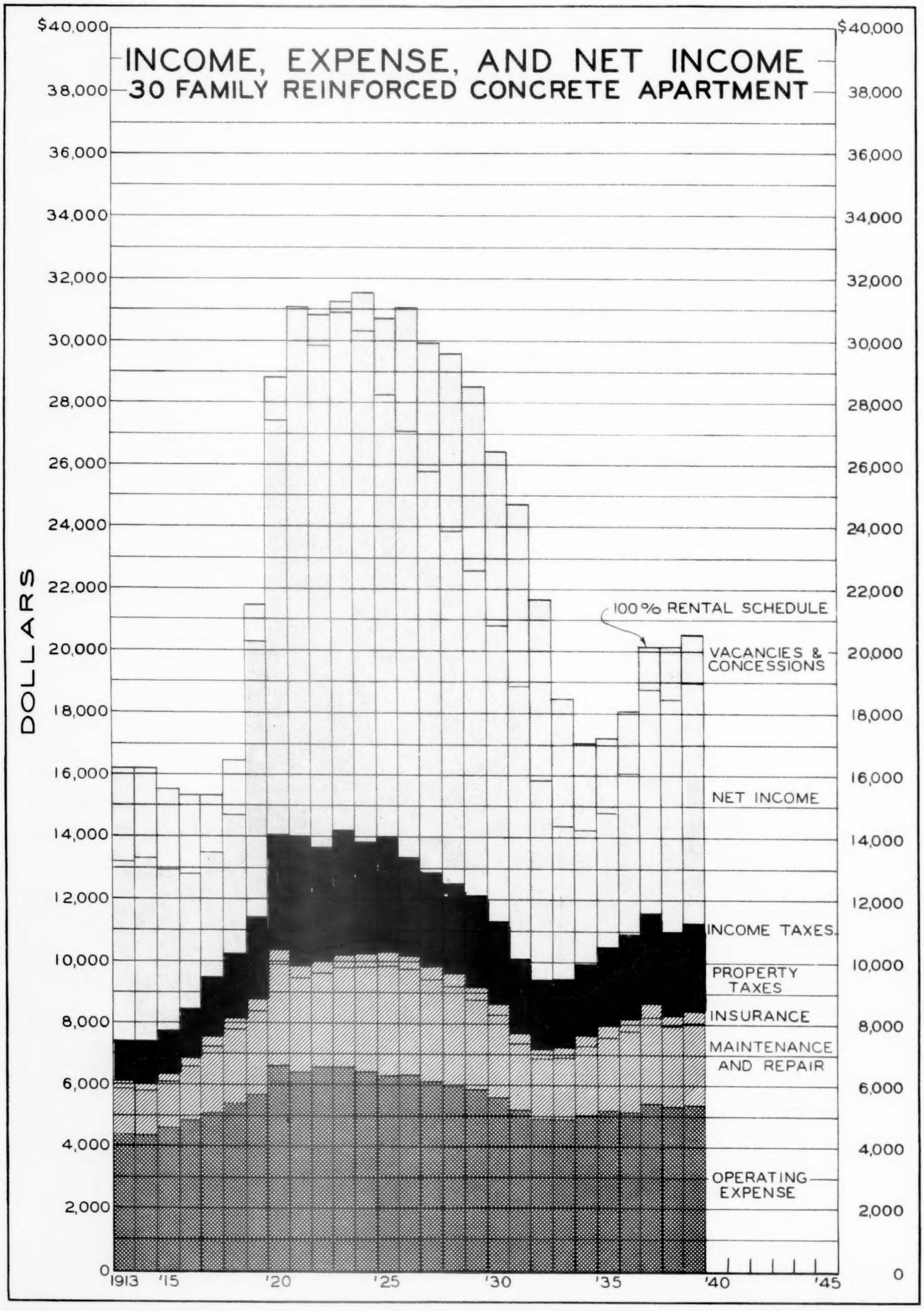
Unfortunately, this chart does not show the period of peak taxes which occurred in 1931, with an average of $162.50 per family.

As a result of the last war, real estate taxes increased by about 162%. They will probably show a large increase again during the next ten to fifteen years, if the present war continues in Europe, and, particularly if the U.S. should later become involved. The difficulty, however, this time is that taxes will start from a level approximately twice the height of the pre-World War level. Offsetting this discrepancy, however, is the fact that rents and values are also considerably above the 1914 figures.



The chart above shows the dollar total of government debts. It will be noticed that government debt increased rapidly from the time that the U.S. entered the World War, and that it continued the increase until the middle of 1919, and then a gradual decline started.

Since 1933, the federal debt has been advancing again at a rapid rate, and the increase in the debt from 1933 to the present is practically equivalent to the increase in the debt caused by the World War. We believe that it is more or less inevitable that the government debt will increase for several more years, and we doubt very seriously whether it will be paid in dollars of the present purchasing power. At least some degree of inflation seems inevitable throughout the world as the result of the present war coming at a time when debts had already reached the danger point. World inflation will pull the U.S. along.


INCOME, EXPENSE, AND NET INCOME
30 FAMILY REINFORCED CONCRETE APARTMENT
DOLLARS
$40,000
38,000
36,000
34,000
32,000
30,000
28,000
26,000
24,000
22,000
20,000
18,000
16,000
14,000
12,000
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8,000
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1913
'15
'20
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'45
100% RENTAL SCHEDULE
VACANCIES & CONCESSIONS
NET INCOME
INCOME TAXES
PROPERTY TAXES
INSURANCE
MAINTENANCE AND REPAIR
OPERATING EXPENSE

INCOME, EXPENSE AND NET RETURN

THIRTY FAMILY REINFORCED CONCRETE APARTMENT

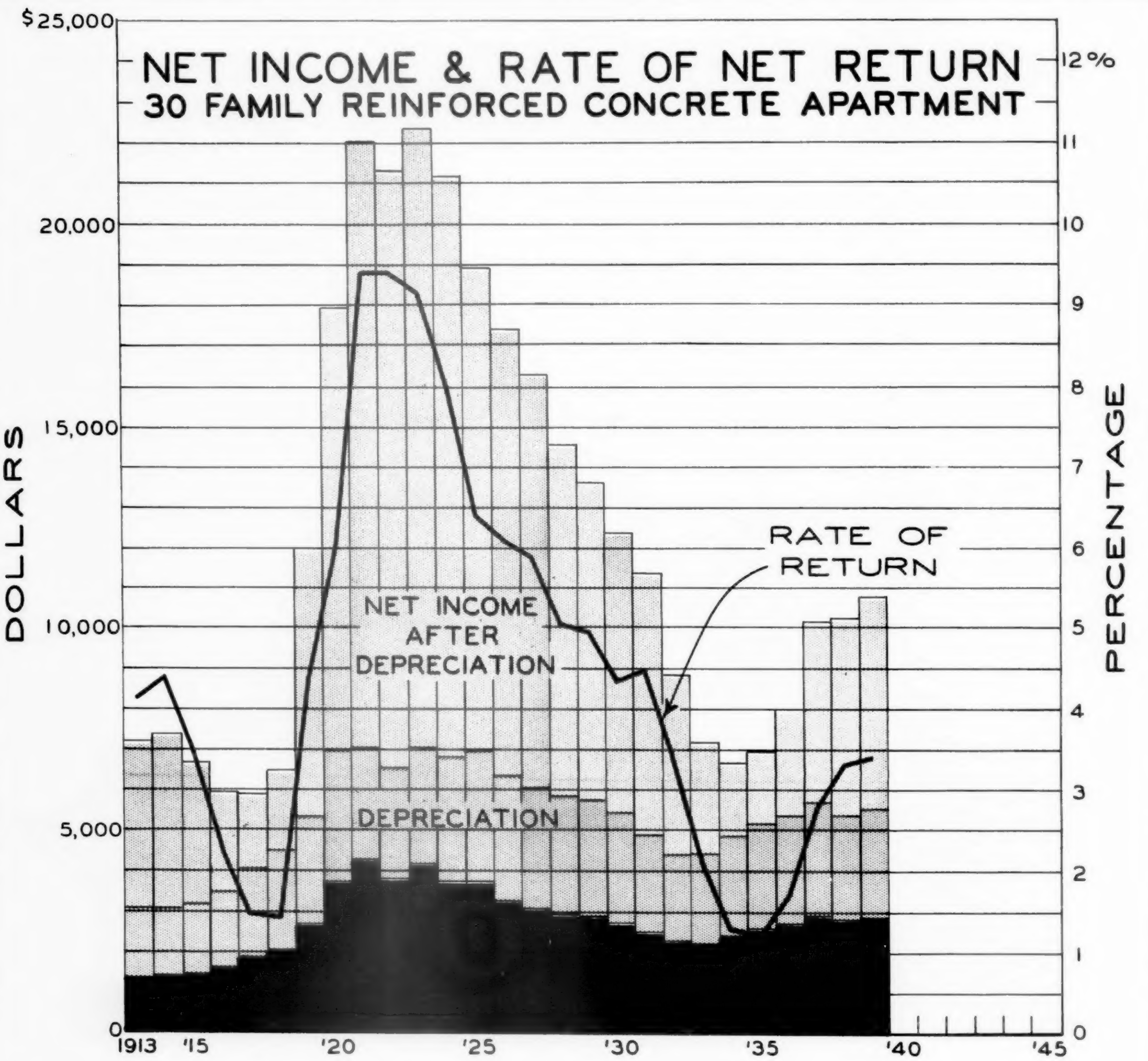
IN the November, 1939, issue of the REAL ESTATE ANALYST, construction costs of a thirty family reinforced concrete apartment building are given in detail for each year from 1913 to 1939 inclusive. The chart on page 22 of this issue, and the table below give income, expense, and net income for the identical apartment by years during the same period. The chart on page 24 shows the net income before taxes and depreciation are deducted. Depreciation is calculated each year as 2% of the cost of the improvements as given in the November, 1939, REAL ESTATE ANALYST. On this chart the rate of return in per cent is indicated by the solid black line This is the relation of the net income after the deduction of taxes and depreciation, to the total cost of land and improvements.

It is believed that these figures represent the actual conditions in Saint Louis with a reasonable degree of accuracy. They are calculated from an identical apartment actually built in Saint Louis and from data, indexes and information collected in the appraisal of many apartment properties. A site of comparable environment and equal desirability is used each year. Also, no reduction in rents due to obsolescence of neighborhood or property is made as a new property is assumed for each year. While the data used covers the City of Saint Louis, it is believed to be fairly representative of other metropolitan cities. The table gives the figures used which can be adjusted to meet differing conditions in other cities if so desired.

It will be noticed that the rate of net return was above 6% only during the period from 1920 to 1926 inclusive, out of the entire 27 years. It rose above 9% in 1921, 1922 and 1923. In all other years the rate of net return was below 6%,dropping below 2% in the years 1917,1918, 1934, 1935 and 1936. The charts show that in 1925 things started to slip due to lower rents, greater loss in gross income and consequent less net income, making it below the net income of the previous four years.

It is generally recognized that the net rate of return after depreciation represents a sound measure of the incentive to build. When this rate is high, there is a strong incentive to construct comparable properties; when this rate is low, such incentive is lacking. While there is a definite lag between the actual construction and the incentive to build, which is estimated to be between two to three years, the fact that over 71% of apartment properties built during the twenties were constructed from 1925 to 1930 indicates some incentives other than the net returns from the projects themselves.

With the wisdom of hindsight, it is apparent that the controlling incentives to build apartment properties in the golden twenties were: (1) the strong demand of the public for the now historic 6% gold bonds; (2) the high financing fees and profits to the mortgage banker, and (3) contractors' profits. When these incentives replaced the only sound incentive of net return, warped judgement took the saddle and rode for a fall.



Year	100% Rental Schedule	Vacancies and Concessions	Total Operating Expense	Maintenance and Repair Expense	Property Taxes and Fees	Insurance	Net Income Including Income Tax	Depreciation	Net Return After Depreciation	Net Return to Total Cost
1913	$16,248	$2,988	$4,336	$1,522	$1,320	$257	$5,825	$1,691	$4,134	4.15 %
1914	16,248	2,898	4,316	1,480	1,358	250	5,951	1,644	4,307	4.43 %
1915	15,558	2,608	4,591	1,520	1,393	257	5,189	1,687	3,502	3.48 %
1916	15,368	2,538	4,854	1,775	1,548	285	4,368	1,874	2,494	2.27 %
1917	15,368	1,898	5,113	2,175	1,797	333	4,052	2,177	1,875	1.50 %
1918	16,478	1,808	5,418	2,430	2,005	371	4,446	2,430	2,016	1.45 %
1919	21,508	1,258	5,714	2,663	2,201	406	9,266	2,669	6,597	4.35 %
1920	28,856	1,396	6,630	3,240	2,901	493	14,196	3,244	10,952	6.02 %
1921	31,080	1,110	6,393	3,050	2,349	420	17,758	2,772	14,986	9.40 %
1922	30,830	930	6,611	3,010	2,400	417	17,462	2,737	14,725	9.40 %
1923	31,226	310	6,597	3,190	2,472	441	18,216	2,899	15,317	9.15 %
1924	31,550	1,250	6,392	3,395	2,673	469	17,371	3,085	14,286	8.02 %
1925	30,720	2,470	6,290	3,535	2,881	490	15,154	3,214	11,940	6.42 %
1926	31,020	3,950	6,305	3,400	2,798	473	14,094	3,092	11,002	6.11 %
1927	29,920	4,120	6,102	3,285	2,712	455	13,246	2,985	10,261	5.89 %
1928	29,620	5,720	5,934	3,220	2,694	447	11,605	2,931	8,674	5.06 %
1929	28,546	5,896	5,842	2,920	2,738	443	10,707	2,905	7,802	4.95 %
1930	26,480	5,620	5,621	2,692	2,574	374	9,599	2,697	6,902	4.35 %
1931	24,730	5,830	5,218	2,162	2,292	368	8,860	2,410	6,450	4.50 %
1932	21,656	5,856	4,922	1,935	2,069	327	6,547	2,110	4,437	3.43 %
1933	18,456	4,156	4,912	1,990	2,126	336	4,930	2,209	2,721	2.08 %
1934	17,018	2,818	5,036	2,200	2,350	373	4,241	2,443	1,798	1.28 %
1935	17,198	2,438	5,178	2,325	2,513	394	4,342	2,584	1,758	1.21 %
1936	18,056	1,946	5,160	2,646	2,580	403	5,266	2,653	2,613	1.72 %
1937	20,160	1,310	5,402	2,805	2,730	427	7,486	2,807	4,423	2.78 %
1938	20,160	1,720	5,348	2,570	2,503	392	7,627	2,573	4,887	3.31 %
1939	20,530	1,550	5,384	2,660	2,587	407	7,942	2,660	5,205	3.41 %

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Enthusiasm and over-optimism of persons who did not know were universal throughout the country. Dependence on experience alone, a lack of facts and ignorance of basic principles must be the only real alibi of those who were then in charge. To claim that these men knew the consequences of their actions, and then gave false advice, loading friends and clients with questionable and in some cases worthless bonds, would be an unwarranted accusation. We confess that at that time we, too, were ignorant of the existence of a real estate cycle. It was only after the depression was well under way that intense research was undertaken, which led to the formation of this company in 1932.

Since the twenties, more effort has been expended to collect facts and to determine the underlying principles which cause real estate to fluctuate in wide swings than in the previous fifty years. Real Estate Analysts, Inc., discovered the real estate cycle which has remained remarkably uniform as to length and intensity for 150 years, regardless of wars, disasters, political parties or monetary changes. Vast amounts of information on the fundamentals of real estate are available today which in the twenties were unknown. Certainly, in the field of real estate, there is available today to the owner, the mortgagee, construction interests, mortgage banking interests, the property manager and the broker, a storehouse of collected knowledge for the guidance of their operations. Because of this, they may today anticipate future trends--in spite of the present European war--with an assurance not formerly possessed.

It is difficult to attempt comparisons between 1925 and 1940. In the former period, construction was going ahead at a rapid rate, the building industry was employed to near maximum capacity, material prices and wages were high and profits were large. High rents, large financing fees,high interest rates and an active real estate market made operations profitable to the property manager, mortgage banker and broker. Those were golden days for the various agencies of the real estate business.

Today, conditions are practically reversed, with construction staggering ahead at a slow pace which is a fraction of capacity, material prices are comparatively lower, and wages paid represent compromises of high wage scales with meager profits to contractors. In the present period of low rents, interest rates and financing fees as well as an inactive real estate market, the various agencies in the real estate business are necessarily complaining of poor business.

To practically all interests in the field of real estate, 1925 would naturally be the choice with the exception of the two most important interests in apartment properties, namely, the equity owner and the mortgagee. These two interests made no profits in 1925, and unknowingly were set to slide to disaster. Today, while all other interests are having difficult times, these two vital interests are in a much more favorable position. For these two interests, the position in 1925 can be likened to the sun past its meridian and starting towards its setting; while today, the morning sun is just rising on the horizon.